Office of Inspector General

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FDIC's Insured Depository Institution Closing Procedures

AUDIT REPORT

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FDIC
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Office of Audits
Office of Inspector General

DATE: June 30, 2004

MEMORANDUM TO: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

[Electronically produced version; original signed by Stephen M. Beard for Russell Rau]

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *FDIC's Insured Depository Institution Closing Procedures* (Report No. 04-023)

This report presents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of the FDIC's insured depository institution closing procedures related to the preparation of Proforma financial statements and the coordination of asset servicing functions. Both of these functions are described in detail in the background section of our report. Because we found no significant exceptions, we terminated our field work on this audit after completion of the audit survey.

The objective of this audit was to determine whether the FDIC's Division of Resolutions and Receiverships (DRR) has established and implemented adequate procedures for (1) preparing Proforma financial statements and (2) coordinating asset servicing functions. The scope of our audit included the two largest insured depository institutions that were closed during calendar year 2003: Southern Pacific Bank, Torrance, California (with assets totaling about $1.05 billion), which closed February 7, 2003; and First National Bank of Blanchardville, Blanchardville, Wisconsin (with assets totaling about $35.1 million), which closed May 9, 2003. We did not review asset disposition strategies or other closing activities in conjunction with this audit. Additional details on our objective, scope, and methodology are presented in Appendix I.

BACKGROUND

DRR is responsible for planning and efficiently handling the resolution of failing FDIC-insured depository institutions and providing prompt, responsive, and efficient administration of failing and failed FDIC insured institutions. When an FDIC-insured institution fails or is closed by a federal or state regulatory agency, the FDIC is appointed as receiver.[1] The FDIC's roles and responsibilities when serving as a receiver are defined by specific statutory provisions contained in the Federal Deposit Insurance Act (FDI Act) of September 21, 1950, P.L. No. 797, as codified at 12 United States Code (U.S.C.) section 1821(d), *Powers and Duties of the Corporation as Conservator or Receiver*. Specifically, the power to control an institution's assets includes the

[1] A receiver is an agent appointed by a failed institution's primary federal regulator to manage the orderly liquidation of the failed institution.

power to "conduct all business of the institution," section 1821(d)(2)(B)(i); "perform all functions of the institution … consistent with the appointment as conservator or receiver," section 1821(d)(2)(B)(iii); and "preserve and conserve the assets and property of such institution," section 1821(d)(2)(B)(iv).

The primary objective of the FDIC as receiver is to maximize the value of the failed institution's assets in order to limit losses to the deposit insurance funds and repay uninsured depositors and general creditors. DRR has an important role in liquidating these assets in the most cost-effective manner possible.

Upon institution failure, some or all of the assets of the failed institution may be purchased by a healthy insured financial depository institution through a Purchase and Assumption Transaction (P&A).[2] Any remaining assets or liabilities will be placed in receivership. DRR appoints a Receiver in Charge (RIC) who is responsible for planning all DRR operational activities to prepare a failing institution for receivership. The RIC also coordinates efforts with a Closing Manager who is responsible for managing and coordinating all activities related to the preparation and closing of an institution.

The FDIC's Receivership Management Program, one of the FDIC's three main business lines, includes performing the closing function at the failed institution, maintaining the value of and liquidating any remaining failed institution assets, and distributing any proceeds of the liquidation to those with approved claims of the receivership. The primary focus of the closing function involves the financial closing process, which encompasses the Proforma, asset servicing, and tax functions.[3] Procedures and guidance for these functions are contained in DRR's *Failed Financial Institution Closing Manual,* dated September 2002, and *Proforma Training Manual,* dated September 2002. We did not include the tax function in the scope of our audit.

Proforma Function

Completion of the Proforma function is the main objective of the closing weekend, which involves controlling, inventorying, and balancing the books of the failed institution. According to the *Proforma Training Manual,* the primary focus of Proforma is to produce a final Statement of Condition that reflects a reasonably accurate financial condition of the failed financial institution and separate financial statements that reflect assets and liabilities passed to the acquirer or retained by the receiver based on the terms of the governing P&A agreement. DRR assigns a Proforma team to the closing, consisting of a Financial Manager, Proforma Team Leader, and Proforma Support Staff. The Financial Manager is responsible for oversight of the financial closing process. The Proforma Team Leader directs the Proforma process for the failed

[2] A P&A is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed institution and assumes some or all of the liabilities, including all insured deposits.

[3] The tax function includes assuring that all tax-related responsibilities of the receivership are properly addressed and obtaining all information necessary to fulfill the tax reporting responsibilities remaining with the receivership.

institution. Proforma Support Staff are responsible for reconciling and confirming the general ledger accounts of the failed institution and adjusting, if necessary, the account balances. This confirmation process is controlled through the use of Proforma Jackets,[4] which support the closed institution's final Statement of Condition. One or more jackets are prepared for each general ledger account. DRR's reconciliation of the last general ledger balance with the bank's final closing balance is documented on the outside of the jacket, which is illustrated in Appendix II.

Asset Servicing Functions

In performing the asset servicing functions, DRR assesses the institution's asset portfolio, provides for interim servicing, and initiates conversion of the failed financial institution's assets to either an external servicer and/or the FDIC's in-house servicing system. The asset servicing functions provide support, direction, and guidelines for accurately accounting for and reporting of assets during the interim servicing period and conversion process. A DRR Team Leader directs the work of the DRR asset servicing staff and coordinates the functions with the DRR Asset Manager, Proforma Team Leader, Financial Manager, and Division of Information Resources Management (DIRM) Manager during the initial stages of the closing process. The Team Leader is responsible for ensuring that conversions are completed in a timely manner and are accurately coordinated with DRR's Franchise Marketing section, which is responsible for marketing the failed institution to prospective bidders.

DRR's 2004 Strategic Plan includes a goal of marketing at least 85 percent of the book value of a failed financial institution's saleable assets within 90 days of failure. Therefore, the strategies of DRR's Franchise and Asset Marketing and Asset Management sections are considered in the coordination of the asset servicing functions during the closing weekend. Generally, loan pools to be offered for sale with the failed institution will consist primarily of performing loans, defined as loans that are less than 60 days delinquent.[5] Servicing of these loans would generally remain with the servicing function in place at the time of closing until the sale is closed. Loan pools to be offered for sale separate from the franchise transaction include nonperforming and unique or unusual performing loans for which the market may be specialized or when the pre-closing sale may not generate adequate competition for that loan pool. The RIC determines whether to service these loans in-house using DRR staff or to continue the existing external servicing arrangement. This determination is made based on input from DRR Franchise and Asset Marketing and Asset Management staffs regarding estimated timeframes for assets to be sold or otherwise liquidated by payoff or negotiated settlement with the borrower. DRR maintains an inventory of loan and other asset data on the FDIC's National Asset Inventory System (NAIS).[6] Loans that are serviced in-house by DRR staff are converted to the FDIC's

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[4] Proforma Jackets contain information gathered through the Proforma process that verifies and reconciles the failed institution's general ledger accounts.
[5] The DRR standard loan sale agreement defines a performing loan as any loan for which the last payment of required principal, interest, and any escrow amounts occurs less than 60 days prior to the calculation date for the sale.
[6] NAIS is a data repository used by DRR to maintain an inventory of all FDIC assets in receivership.

National Processing System (NPS),[7] which DRR staff use to record new assets and subsequent financial adjustments. DRR prepares an Asset Reconciliation of the total assets of the failed financial institution. The reconciliation identifies assets being converted to the NPS, external servicers, and other interim servicing arrangements.

RESULTS OF AUDIT

Based on our review of the two largest banks that failed in 2003, we determined that DRR has established and implemented effective guidance and procedures for preparing Proforma financial statements and coordinating the asset servicing functions.

- DRR's guidance for preparing Proforma financial statements identifies the roles and responsibilities of the closing team and provides step-by-step procedures and detailed checklists for completing Proforma Jackets for each account. We found no significant exceptions during our review of Proforma financial statements and supporting Proforma Jackets for the two bank closings. Additionally, Proforma teams included personnel with sufficient training and expertise to perform required Proforma assignments. (See Finding A: Proforma Financial Statements.)

- DRR has established effective procedures for coordinating asset servicing functions. Assets from the two failed banks we reviewed were appropriately converted to FDIC's NPS and were reconciled to the Proforma financial statements. Further, loan and other asset records from the two failed banks were appropriately transferred and recorded in the FDIC's NAIS. (See Finding B: Coordination of Asset Servicing.)

Because we found no significant exceptions during our audit work, we are making no recommendations related to the audit objective.

[7] NPS is an asset processing system DRR uses to account for loans and related financial transactions acquired from failed financial depository institutions.

FINDING A: PROFORMA FINANCIAL STATEMENTS

Our review of the two largest banks that failed in 2003 showed that DRR has established adequate procedures for preparing Proforma financial statements during the closing of failed institutions. Specifically, the Proforma teams properly confirmed and adjusted general ledger accounts of the failed institutions. Further, DRR's Proforma files supported the closed institutions' final Statements of Condition, and Proforma Jackets were complete and prepared in accordance with DRR procedures. Also, DRR staff assigned to Proforma teams received adequate training and had the experience necessary to perform their assigned duties during the bank closings.

Proforma Guidance

DRR's *Proforma Training Manual*, dated September 2002, provides detailed procedures for completing Proforma financial statements. The guidance identifies the roles and responsibilities of the closing team and provides step-by-step procedures and detailed checklists for Proforma team members in preparing Proforma Jackets for each account. The procedures addressed all Proforma steps for various types of bank closing transactions.

We compared the Proforma financial statements and supporting Proforma Jackets used to document the confirmations and adjustments of the two failed institutions' general ledger accounts with the respective final Statement of Condition for each institution. We reviewed and tested 40 of the 89 Proforma Jackets related to the Proforma financial statements for Southern Pacific Bank and all 41 Proforma Jackets related to the Proforma financial statements for First National Bank of Blanchardville. We concluded that the jackets were accurately calculated and that adjustments were adequately supported and found no significant exceptions related to either closing. We noted minor exceptions, however, related to signatures of approving officials on five Proforma Jackets. The *Proforma Training Manual* requires that each Proforma Jacket be signed by both the Proforma Team Leader and the Financial Manager. However, only the Team Leader had signed three of the jackets for the Southern Pacific closing. Two of the jackets for the Blanchardville closing had only the Financial Manager's signature. All other jackets were properly signed by both reviewers. Considering that the Proforma Jackets we reviewed were accurate and reviewed by at least one supervisor, we concluded that this issue did not warrant additional audit testing or management attention.

DRR had pre-assigned Proforma teams to conduct the Proforma work at bank closings. We sent a questionnaire to 30 Proforma team members regarding the number of bank closings they had attended and the extent of Proforma training they had received. Team members reported working an average of 4 years in the Proforma Function; 27 of the 30 Proforma team members had worked on at least 3 bank closings; and 24 members had experience in at least 5 or more bank closings. Proforma procedures have remained generally the same since 1999, and every member either had taken a Proforma training class during the last 4 years or was scheduled to take Proforma training in 2004. Further, DRR has established a computer-based training course to provide training for DRR staff as needed.

FINDING B: COORDINATION OF ASSET SERVICING FUNCTIONS

Based on our review of the two failed banks, we determined that DRR has established and implemented effective procedures for coordinating the asset servicing functions during the closing of failed financial institutions. DRR's *Failed Financial Institution Closing Manual* (Closing Manual), *Conversions Manual*, and *Asset Disposition Manual* provide adequate guidance and internal controls on the roles and responsibilities for pre-closing evaluations, conversions, and interim servicing procedures. We found that the files related to the asset coordination functions at the closings of Southern Pacific Bank and First National Bank of Blanchardville contained adequate documentation evidencing that assets of the failed financial institutions were properly converted to FDIC systems.

Procedures for Coordinating Asset Servicing Functions

Procedures for coordinating asset servicing functions during the closing of failed financial institutions are included in DRR's Closing Manual, dated September 2002, and *Conversions Manual,* dated January 2000. Our review of these documents showed that both manuals provide detailed procedures and sufficient guidance for DRR closing personnel to perform the asset servicing functions. For example, the Closing Manual includes detailed checklists on the roles and responsibilities of closing team members and descriptions of tasks to be completed. Examples of documents to be used such as letters and receipts are also included. The *Conversions Manual* describes interim servicing procedures, the pre-closing assessment, and related closing responsibilities. The manual also includes examples of documents to be completed and contains detailed descriptions of responsibilities for coordinating asset servicing functions.

Asset Servicing

Southern Pacific Bank was closed on February 7, 2003 with assets totaling about $1.05 billion. First National Bank of Blanchardville was closed on May 9, 2003 with assets totaling about $35.1 million. We reviewed closing files for the two institutions, including the loan portfolio summary, conversion files, asset reconciliation reports, NPS inventories, and NAIS inventories. Details on the conversion of the failed banks' assets as of the closing dates are shown in the table on the next page.

Conversion of the Two Failed Banks' Assets

Failed Bank	Failure Date	Type of Resolution	Number and Book Value of Initial Assets	Number and Book Value of Assets Assumed by the Acquiring Bank	Number and Book Value of Assets with an External or Interim Loan Servicer	Number and Book Value of Assets Transferred to DRR for Servicing
Southern Pacific Bank	02/07/2003	P&A	955 $1.05 billion	42 $205 million	843 $626 million	70 $220 million
First National Bank of Blanchardville	05/09/2003	P&A	771 $35.1 million	None	None	771 $35.1 million

Source: DRR Receivership Status Reports.

To determine whether assets of the failed institution were properly converted to FDIC systems, we selected a random sample of 50 assets from the records for Southern Pacific Bank and 30 assets from the records for First National Bank of Blanchardville. We obtained access to the FDIC's NAIS to verify that all of the assets had been recorded in the FDIC's asset inventory. We located all 80 of the assets and found no exceptions. Also, we reviewed conversion files to determine whether adequate documentation was maintained on the conversion process in accordance with DRR's *Conversions Manual*. We found conversion files that adequately documented the status of those loans converted to the NPS. Further, we verified that Asset Reconciliation reports reconciled to the Proforma financial statements and accounted for assets converted to the NPS.

CORPORATION COMMENTS

A written response was not required for the report. DRR advised the OIG that it had no official comments and identified two minor but needed revisions, which we incorporated into the report.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine whether DRR has established and implemented adequate procedures for preparing Proforma financial statements and coordinating asset servicing functions. We reviewed the DRR policies and procedures established for closings of failed financial institutions. The audit scope included the two largest FDIC-insured depository institutions closed in 2003. We terminated our field work on this audit after our survey work based on the results of testing we performed. We performed our work from February through April 2004 in the DRR Dallas Regional Office and Washington, D.C., office in accordance with generally accepted government auditing standards.

To accomplish our objectives and to gain an understanding of internal controls, we reviewed the following DRR documents.

- *Failed Financial Institution Closing Manual*, September 2002
- *Proforma Training Manual,* September 2002
- *Conversions Manual*, January 2000
- *Asset Disposition Manual*, October 2002
- *Monitoring Plan for Residential Mortgages*, October 2003
- Closing Book for First National Bank of Blanchardville
- Inventory Book for First National Bank of Blanchardville
- Asset Reconciliation for Southern Pacific Bank and First National Bank of Blanchardville
- Proforma files for Southern Pacific Bank and First National Bank of Blanchardville

We interviewed key personnel in DRR's Accounting Operations, Franchise and Asset Marketing, and Asset Management sections to further obtain an understanding of the procedures and processes involved in the Proforma and asset servicing functions at the closing of a failed financial institution.

To test the accuracy and completeness of the procedures for completion of the Proforma financial statements, we reviewed all 41 of the Proforma Jackets from the closing of First National Bank of Blanchardville and 40 (45 percent) of the 89 Proforma Jackets from the closing of Southern Pacific Bank. We recalculated the adjustments for each jacket and compared them to the supporting documentation. Also, we verified whether the jackets contained the appropriate signatures as required by DRR's *Proforma Training Manual*. To obtain information on the Proforma bank closing experience and training of the DRR Proforma teams, we sent a questionnaire to the team members and received 30 responses.

To evaluate procedures for the coordination of asset servicing related to the closings of Southern Pacific Bank and First National Bank of Blanchardville, we reviewed Asset Reconciliation reports, conversion files, DRR External Servicer Reports, National Processing System Inventories, closing books, and related documentation.

To determine whether assets from the records of the failed institutions had been accurately recorded by the FDIC, we selected a random sample of 80 assets from the population of 1,726 assets in the records of the 2 failed banks and verified that the assets were included in the FDIC's NAIS.

Government Performance and Results Act, Reliance on Computer-Generated Data, Fraud and Illegal Acts, Compliance with Laws and Regulations, and Management Controls

To determine whether DRR had any performance measures that we should consider in this audit, we reviewed DRR's 2004 Strategic Plan. The plan includes a goal of marketing at least 85 percent of the book value of a failed institution's saleable assets within 90 days of failure. This goal was not specifically related to our audit objective. However, DRR includes another goal to ensure that the Receivership Status Report and Action Plan are finalized within 120 days of failure. We reviewed the Receivership Status Reports for the two failed institutions included in our audit scope and found both reports had been completed within 120 days of the failure date of the institutions.

We did not rely on the accuracy of computer-processed data and did not perform any work to determine the reliability of computer-processed data. Not performing assessments of computer-processed data did not affect the results of our audit.

Our audit program did include steps for providing reasonable assurance of detecting fraud or illegal acts. We gained an understanding of applicable laws and regulations by examining the Federal Deposit Insurance Act of September 21, 1950, P.L. No. 797, as codified at 12 United States Code, section 1821(d), *Powers and Duties of the Corporation as Conservator or Receiver.* Also, our audit testing covered aspects of internal controls, and no significant exceptions were noted during these audit tests.

FEDERAL DEPOSIT INSURANCE CORP.
PROFORMA JACKET

General Ledger Balance				$
Pro Forma Adjustments:	ADJ REG #	Jacket #	PRO FORMA #	
Adj From This Jacket:				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
Subtotal				$
Adj From Other Jackets:				
DR				
CR				
DR				
CR				
DR				
CR				
DR				
CR				
Adjusted Pro Forma Balance				$
Less: Assuming Bank Portion				
FDIC Portion				$
DACS Adjustments:				
DR				
CR				
DR				
CR				
Adjusted FDIC Balance				$

FAILED INSTITUTION NAME AND ADDRESS:

AFFIX PR LABEL HERE

CLOSING DATE:

Reason:

( )
( )
( )
( )
( )
( )
( )
( )
( )

INITIATED ADJUSTMENTS
(THIS JACKET)

Prepared by Pro Forma Support:

( )
( )
( )
( )

INCOMING ADJUSTMENTS
(FROM ANOTHER JACKET)

Reviewed by Pro Forma Manager:

( )
( )

DACS OR LAS ADJUSTMENTS
CASH BASIS FOR FDIC ASSETS

Reviewed by LAS Manager:

Follow-up: YES ( ) NO ( )	Comments: